ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Kehoe and Shelley | Analyst: Marion Mann DeJong | Bill Number: AB 29X

Related Bills: | Telephone: 845-6979 | Introduced Date: 02/05/2001

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Small Business Commercial Refrigeration Replacement Credit

SUMMARY

This bill would create a tax credit for small businesses that replace commercial refrigerators with energy efficient refrigerators.

This bill also would amend the Public Resources Code, creating other measures to promote the conservation of energy. These changes do not affect the department and are not discussed in this analysis.

PURPOSE OF THE BILL

Based on the Legislative intent stated in the bill, the purpose of the tax credit appears to encourage small businesses to conserve energy by replacing refrigerators that are energy inefficient.

EFFECTIVE/OPERATIVE DATE

As an urgency statute, this bill would become effective immediately upon enactment. However, the bill specifies that the income tax credit would be operative for taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to define “commercial refrigeration unit” and “more energy-efficient model.” Also, amendments are needed to clarify what costs qualify for the credit and how the $2,000 limitation is applied. See “Implementation Considerations” below. Department staff is available to assist the author with amendments to resolve these concerns, as well as the legal concerns, policy concerns, and technical considerations addressed below.

Board Position:			Department Director	Date
______ S	______ NA	______ NP	Alan Hunter for GHG	02/14/01
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ANALYSIS

FEDERAL/STATE LAW

Both state and federal law exclude from income amounts received as energy conservation subsidies from a public utility. The subsidies must be for the purchase or installation of energy conservation measures designed to reduce the consumption of electricity or natural gas or to improve the management of energy demand and must be installed on dwelling units.

Both state and federal law allow a deduction for all ordinary and necessary expenses of a trade or business, including expenses relating to energy conservation measures. If the expense is a repair to existing equipment that does not extend the useful life of such equipment, it is deductible in the year paid or incurred. If the expense is a replacement and the useful life of the equipment replaced is more than one year, or the repair extends the useful life of the equipment, the cost of the item is recoverable through depreciation over the useful life of the equipment.

Both state and federal laws provide various tax credits designed to provide tax relief for taxpayers that must incur certain expenses (e.g., renter's credit) or to influence behavior, including business practices and decisions (e.g., research credits).

Neither state nor federal laws have a credit comparable to the credit proposed by this bill.

THIS BILL

Under the Personal Income Tax law, this bill would create a tax credit for small businesses that replace commercial refrigeration units with energy efficient units. The credit would equal 30% of the cost of replacing a commercial refrigeration unit with a more energy-efficient model, not to exceed $2,000. The credit would not apply to corporations. The bill directs the State Energy Resources Conservation and Development Commission to administer this credit.

The credit would not reduce regular tax below tentative minimum tax for alternative minimum tax purposes. Any unused credit could be carried forward for a maximum of five years.

"Small business" would be defined by Section 14837(d)(1) of the Government Code to mean a manufacturer (included in Standard Industrial Classification (SIC) Codes 2000 to 3999) with 100 or fewer employees or a business that meets all of the following tests :

- is independently owned and operated;
- not dominant in its field of operation;
- has its principal office located in California;
- has officers domiciled in California;
- has 100 or fewer employees (including it affiliates); and
- has average annual gross receipts of $10,000,000 or less over the previous three years (including affiliates).

IMPLEMENTATION CONSIDERATIONS

The department has identified the implementation concerns listed below. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- The terms "commercial refrigeration unit" and "more energy-efficient model" are not defined. Undefined terms can lead to disputes between taxpayers and the department.

- It is unclear whether the $2,000 limit is a limit on the credit amount or a limit on the cost of the refrigeration unit qualifying for the credit. For example, if a refrigeration unit costs $30,000, the credit could be $2,000 (30% of $30,000 = $9,000, but limited to $2,000) or $600 (30% of cost not to exceed $2,000 = $600).

- It is unclear what costs qualify for the credit. The credit is equal to 30% of the "cost of replacing a refrigeration unit." This could include more than the sales price of the unit. It could include costs such as delivery costs, set-up costs, labor costs, sales or use tax paid, and remodeling costs.

- Taxpayers and department staff do not have independent expertise in the area of energy efficient commercial refrigeration units and thus may have difficulty determining if a refrigeration unit is "more energy-efficient" than the one it is replacing. A methodology for measuring the increased efficiency and having independent expert verification of the increased efficiency would help the department in administering this credit.

- The responsibilities of the Energy Resources and Conservation and Development Commission in administering this credit are unspecified.

- The bill limits the credit to a small business as defined in the Small Business Procurement and Contract Act. This definition is imprecise, uses undefined terms, and will be difficult to administer.

TECHNICAL CONSIDERATIONS

The word "credit" is repeated twice in the first subdivision of the credit. Department staff is willing to draft the amendment to improve this language when resolving the implementation concerns.

OTHER STATES' INFORMATION

Although *Massachusetts, Michigan*, and *New York* do not provide a tax credit comparable to the credit proposed in this bill, the following is a brief list of their incentives provided for energy conservation. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Massachusetts has an extensive program of tax exemptions and credits designed to encourage the consumption and production of energy efficient and alternative energy systems. These tax benefits include the following: individuals are allowed a credit for the purchase and installation of solar or wind energy system for their residence; and businesses are allowed a deduction for the purchase and installation of solar and wind energy systems for heating, air conditioning, or water heating purposes.

Michigan does not generally provide energy conservation incentives through the tax system but uses an extensive system of grant and loan incentives to encourage investment in alternative energy and energy conservation.

New York has programs designed to effect both the consumption and the production of energy conservation systems and alternative energy equipment. Individuals are allowed a credit equal to 25% of certain solar electric generating expenditures.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department's costs are expected to be minor.

ECONOMIC IMPACT

<u>Tax Revenue Estimate</u>

Although speculative at this time due to definitional issues, the magnitude of revenue losses could easily be on the order of $5 to10 million annually under the PIT Law beginning in 2002-03. This magnitude assumes a maximum credit of $2,000 per commercial refrigeration unit and that units are used or installed in businesses located in California. In the event the bill is amended to include corporations, the potential revenue loss would be substantially larger.

<u>Tax Revenue Discussion</u>

The revenue impact of this bill would be determined by the amount of credits that could be applied to reduce tax liabilities in any given year. For purposes of the range estimate above, the following data and assumptions were applied:

Commercial refrigeration includes food service, supermarket, environmental/medical, transport, and industrial applications. It is estimated that there are roughly 100,000 establishments in California within these industry sectors based on available data in the California Statistical Abstract. Assuming half of these meet the definition of "small business" for purposes of the bill, and the number of refrigeration units within each establishment averages two, there would be potentially a total of 100,000 existing commercial refrigeration units in qualifying businesses. The basic components of a modern vapor-compression refrigeration system are a compressor, a condenser, an expansion device, and an evaporator. For more energy efficiency, if 5% of the commercial refrigeration units had one or more parts replaced in any given year and the average applied credit per unit is $1,500 (assumes an average replacement cost of $5,000 per unit), revenue losses would be on the order of $8 million.

LEGAL IMPACT

The bill limits the credit to a small business with officers domiciled in California. The United States Supreme Court has recently held that a state law denying a deduction to a nonresident taxpayer solely on the basis of nonresidency was unconstitutional. The denial of a tax credit to a taxpayer on the basis of the domicile of its officers may be subject to constitutional challenge.

This bill also requires that the principal office of the small business be located within California, another factor that may result in the bill being considered unconstitutional.

ARGUMENTS/POLICY CONCERNS

This bill would provide a tax credit for small businesses operated as a sole proprietorship or partnership but would not provide the same benefit for a corporation. Thus, this bill would provide differing treatment based solely on entity classification. This can cause taxpayer confusion and disputes between taxpayers and the department. This issue can be resolved by adding a corresponding tax credit to the Bank and Corporation Tax Law.

This bill does not limit the credit exclusively to refrigeration units that are used or installed only in California.

This bill would allow a credit for an expenditure that already is deductible or depreciable. Conflicting tax policies come into play whenever a credit is provided for an item that is already subject to another tax benefit. Providing both a credit and allowing the full amount to be deducted would have the effect of providing a double benefit for that item. On the other hand, making an adjustment to reduce basis in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general conformity policy. In the case of a one-time business expense deduction, the reduction of that expense by the amount of the credit would not create an ongoing difference.

This bill does not contain a sunset date. Sunset dates generally are provided to allow periodic review by the Legislature.

The bill does not provide for the recapture of the credit if the refrigeration unit is sold or no longer used within a specified time period.

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